An Analysis of the Whole Life Insurance Policy in Confronting the Risk of Inflation

An Honors Thesis (ID 499)

By

John B. Scheidler

Thesis Director

Dr. Numan A. Williams

Ball State University

Muncie, Indiana

May, 1976

Abstract

AN ANALYSIS OF THE WHOLE LIFE INSURANCE POLICY IN CONFRONTING THE RISK OF INFLATION

John Burns Scheidler

Under the Supervision of Dr. Numan A. Williams

Inflation in every sector of the economy is a significant and growing problem in terms of undermining the value of the dollar. When one considers that in the period 1970-1975, 28 cents was eroded from every dollar by this force, the impact of inflation must be considered in regard to ascertaining ways to hedge against it. At the same time, man is confronted, by the nature of his existence, with risk where he is uncertain as to when he will experience a loss in the future. An individual confronts the risk of death in a variety of ways. The most effective procedure is purchasing one of the many policies available from the life insurance industry.

A specific life insurance policy, the whole life policy, was considered to determine 1) whether it is affected by inflation, 2) whether it is an effective way of hedging against inflation in its present form, and 3) what alternative method of formulating it might be considered to successfully confront the risk of inflation.

The report illustrated the complexity and flexibility of the whole life policy as well as explaining its unique feature of cash values when used as a savings element. At the same time, methods were offered in regard to manipulating the policy loan, settlement option, tax advantage, and variable annuity concepts to provide an effective way of meeting the inflation risk. Also, an analysis was made of the two types of life insurance companies offering the whole life policy, namely stock and mutual, in order to determine the company offering the life insurance protection at a lesser cost.

The study proposed the variable life insurance policy as an alternative method of formulating the whole life policy to effectively hedge against inflation. The discussion ended with a report of the consequences of increased government regulation in the whole life insurance industry.

Conclusions

Based on the study, the following conclusions should be considered:

1) The whole life insurance policy, because it involves a fixed dollar benefit accruing over a long period of time, is greatly affected by inflationary forces. Consideration should be given to ascertaining either methods of manipulating the present whole life policy to meet the inflation risk or to develop an alternative policy formulation which would effectively hedge against inflation.

2) The whole life policy is characterized by its complexity and flexibility. While the complexity exposes it to the adverse effects of inflation more readily and substantially than other types of life insurance coverage, the flexibility enables it to be manipulated by the policyholder in several ways to provide an adequate response to the risk of inflation. A policyholder should take advantage of his policy loan option by investing the borrowed cash reserve in more financially profitable instruments. He should purchase his coverage from a mutual life insurance company in order that the profits earned by the company will be returned to him and not to a profit-seeking stockholder. Also, a policyholder should consider a variable annuity to enable a financially sufficient retirement as well as providing that the proceeds of the policy be handled by a lump sum option to in turn be handled by a banking official.

The whole life policy, however, is not in itself an effective way of meeting the risk of inflation because the fixed dollar accumulation exists which is seriously affected by inflation.

While inflation cannot be eliminated, certain steps can be taken to bring it under control. At the same time, individuals in society need the security and benefits that ownership of a whole life insurance policy offers. Modification, then, of the whole life policy to a variable life policy would serve a dual role by the following: 1) it would help bring inflation under control and 2) it would continue to afford an individual the security and benefits which are necessary for him to substantially function in society.

APPROVED BY Norman A. Williams

DATE May 18, 1976

TABLE OF CONTENTS

SECTION I

AN ANALYSIS OF THE WHOLE LIFE INSURANCE POLICY AS IT IS AFFECTED BY THE RISK OF INFLATION

The Problem

Introduction

Man, by the nature of his existence, must cope with pure risk. Pure risk is differentiated from speculative risk in that with pure risk, one's uncertainty associated with the outcome of an event only involves a loss. An example of speculative risk, on the other hand is gambling where one may either win or lose by the outcome of an event. In attempting to confront this risk, man has a variety of options. He may avoid the risk or assume it. At the same time, he may reduce either the hazard or the loss itself.

One of the best and mose effective ways of combating the uncertainty of a loss dealing with one's life is by transferring or pooling the risk i.e. life insurance. Life insurance, then, is the pooling of resources and the dispersing of death risk. Along these lines, it substitutes certainty for uncertainty by covering one's loss of life. However, as in the case of man's existence, life insurance is not without its own uncertainty of outcome as to economic loss.

The greatest disadvantage of life insurance is inflation which as a future risk, is a very serious question to consider.

Inflation is an economic condition in which prices are steadily rising for a period of time for a representative group of commodities or services.[1] The inflation that affects what one spends on food, fuel, housing, and a host of other things is now creeping into the life insurance industry. Consequently, the life insurance business must accept two stark, unpleasant facts. The first fact is that inflation is probably here to stay. Government controls may curtail its growth, but they will not eliminate it from the economic environment. As the April, 1974 edition of Best's Review asserted, "Inflation must be viewed as a virtually incurable malady which may be likened unto a disease which has so completely inundated the body of the host that it can only be treated and not cured." The second fact is that the problem of inflation will bear more heavily on the life insurance business than on other types of business. This is because the product of life insurance companies has a long lifetime. At the same time, unlike most other businesses, the revenue is fixed but the costs are not

---

[1] Ambrose B. Kelley, "Insurance and Inflation," Insurance Insights, South-Western Publishing Co., Cincinnati, Ohio, p. 276.

in the insurance industry. Also, it experiences a tremendous amount of government regulation which stifles any attempt at innovation.

Experts are saying that premium rates are likely to increase and certain policies may become harder to get. Although autonomous state commissioners decide on higher premiums that companies within their jurisdictions may desire, Charles C. Clarke, Executive Vice-President of Insurance Information Institute, contends that insurance premiums will have to go up and that the increases must be substantial.[1] The effects of these premium increases will decrease the tendency of individuals using life insurance in meeting their pure risk.

To illustrate the disastrous consequences which a high inflation rate will initiate, a 10 percent inflation rate compounded annually for 40 years reduces the purchasing power of $10,000 to a mere $200.[2] At the same time, in the past decade of 1965-1975, consumer prices have jumped nearly 71 percent.[3] Thus, if one had an annual income of $15,000 in 1965, he would have

---

[1] The National Underwriter, (Life and Health Edition), Sept. 14, 1971, p. 6.

[2] U.S. News and World Report, Dec. 15, 1975, p. 74.

[3] Ibid.

needed $25,650 in 1975 to maintain the identical purchasing power.[1] In following, to carry this example one step further, he would need $43,861.50 in 1985 if inflation keeps going at the rate of the past 10 years.[2] Thus, insurance is a trade-off between risk and inflation and by studying these two entities, an individual may efficiently disperse his risk to others while attempting to control inflation.

Statement of the Problem

The purpose of this study is to analyze and define the role of life insurance, present and future, in meeting the risk of inflation.

A specific type of life insurance policy, namely the whole life policy, will be considered to determine 1) whether the whole life policy is affected by inflation, 2) whether the whole life policy as it is now written, is an effective way of meeting the risk of inflation, and 3) what alternate method of formulating the whole-life policy might be considered to successfully hedge against this risk.

Significance of the Study

"Any man who doesn't believe in life insurance deserves to die once without having any."--Will Rogers.

---

[1] Ibid.

[2] Ibid.

The importance of life insurance which this quote implies is realized when one considers that in 1973, 143 million or 2 out of every 3 people in the United States were protected by life insurance with legal reserve companies.[1] At the same time, the average amount of coverage for each insured family in 1973 was $28,800--an increase of $1900 from 1972. The whole-life insurance policy accounted for 52 percent of these totals with 128 million policies and over $928.2 billion.[2]

On the other hand, the June, 1975 Consumer Price Index showed an annual increase of 9 percent.[3] Consequently, with so many people affected by life insurance (specifically through ownership of a whole-life policy), the present and future implications should be considered thoroughly.

Scope of the Study

The effects of inflation are all-encompassing in relation to the economy. As mentioned earlier, these effects are multiplied in the insurance industry because insurers deal with large amounts of money. By collecting premiums from their policyholders from

---

[1]"Retirement Living," Jan., 1975, VOL. 15/ NO. 1, P. 48.

[2]*Life Insurance Fact Book, 1974*, Institute of Life Insurance, p. 27.

[3]"Retirement Living," Oct., 1975, VOL. 15/NO. 10, p. 11.

which they pay present expenses and future losses, the impact of any change in the value of money is of tremendous concern to the insurance institution. This impact revolves on the premise that (as in the case of life insurance) it may be many years after the insurance contract is issued before a claim must be paid. Thus, this study will be limited to the whole life insurance contract because an entity extending over a long period is essential to grasping the consequences of inflation.

At the same time, the nature of the report in that it contends with two broad areas of economic concern to the individual (i.e. inflation and life insurance) must have further limitations to enable this study to be a concise and indepth analysis versus a comprehensive, superficial, and ambiguous study. Therefore, this analysis will consider the implications of inflation on the whole life insurance policy. It will include a brief, general definition of the word "inflation" but the concept will evolve around an understanding that the subsequent price increases which are inherent with inflation, are also constant and steady.

To accomplish this objective, the idea of compounding interest continuously as opposed to annually will illustrate the gradual decline of the value of money and the constant rise in the price of commodities and services. On the other hand, the whole life insurance concept is an excellent instrument to convey the effects of inflation because it is the most basic, widely used and flexible product in the life insurance spectrum. Consequently, the limitations of this study will permit a thorough analysis of the whole life insurance policy in confronting the risk of inflation.

Basic Assumptions

This study will make the following basic assumptions:

1) Inflation adversely affects every sector of the economy.

2) Private insurance exerts a tremendous influence on the economy.

3) Inflation will be expressed as increasing at a constant annual rate of 5 percent.

4) Inflation can be controlled but not eliminated.

5) The flexibility of the whole life policy enables it to meet practically any situation dealing with an individual's attempt to substitute certainty for uncertainty in covering the economic loss associated with his death.

Definitions of Terms Used

Several words or terms in this discussion derive a specific meaning when they are implemented in the context of the whole life insurance policy as it confronts the risk of inflation. Although an attempt has been made to use words which can be interpreted to represent a common, dictionary meaning, a few words need to be noted. Unless stated otherwise in this report, the following words should be interpreted by the definitions given below.

Cash value: A sum of money which results from the whole life policyholder prepaying some of the mortality costs that evolve under the policy. It is used interchangeable with "cash reserve" in this report.

Financed Life Insurance: A method of buying permanent whole life insurance on borrowed dollars and deducting the interst on the loan for income tax purposes. This can be accomplished by borrowing from the cash reserve of the policy or from any type of financial institution. This term will involve borrowing from the cash reserve in this report.

Inflation: An economic condition in which prices are steadily rising for a period of time for a representative group of commodities and services.

Insurance Industry: Those companies, large and small, either stock or mutual, that make up the American market for life insurance.

Level Premium: A plan of whole life insurance under which premiums do not increase from year to year, but instead, remain constant throughout the premium-paying period. It provides with the whole life policy a decreasing amount of insurance and an increasing investment element.

Risk: Uncertainty concerning loss where it represents the uncertainty and not the loss, the cause of loss, or the chance of loss.

Social Insurance: A federal life insurance plan. It is not associated with social security or workmen's compensation.

Whole Life Insurance Policy: Combines the idea of permanent protection with level premiums. It provides for the payment of the face amount upon the death of the insured, regardless of when it may occur. (See Appendix A)

Design of the Study

Following is a brief outline of the study, showing the methods by which it seeks to analyze the whole life insurance policy as it is affected by the risk of inflation. This initial section presents an introduction, the formal statement of the problem under consideration, its significance and scope. It also states the basic assumptions that are made, the definitions of terms used in this study, the outline of the study's design, and a review of related literature.

Section II offers a brief history and a more detailed explanation of the whole life policy. This is done to illustrate the complexity of the policy which in turn creates numerous ways for inflation to affect its operation. Section II also contains a discussion of cash values which are unique to the whole life policy and constitute several advantages to the policyowner when viewed as a savings element.

Chapter III considers whether the whole-life policy as it is now written is an effective way of meeting the risk of inflation. Specifically, it will discuss the advantages and disadvantages of policy loans. Also, there will be a brief explanation of the tax advantages which a whole life policy possesses over other types of investments. Thirdly, Chapter III will examine the merits of the participating stock insurance company. Finally, the effective implementation of settlement options will be viewed from the standpoint of hedging against inflation. Included in this discussion will be a consideration of variable annuities.

Chapter IV will present alternative methods of formulating the whole life policy to offset the risk of inflation. Included in this discussion will be an explanation of variable life insurance. At the same time, Chapter IV will examine the advantages and disadvantages of increased government regulation of the insurance industry as well as the possible benefits arising out of social insurance. Chapter V contains a summary of the study and the conclusions reached as a result of this work.

Related Literature

There have been several magazine articles and a few books written on the effects of inflation on life insurance. The majority of information has come from the National Underwriter (Life and Health Insurance Edition). In addition, the Best's Review (Life Edition) and the "Monthly Economic Letter" of the First National City Bank of New York serve as excellent references in the areas of inflation and insurance.

In regards to books, Robert I. Mehr's, Inflation, Technology and Growth: Possible Long Range Implications for Insurance specifically discusses the subject of this report by using the Delphi technique where analysis of past experience is combined with the expert judgment of a panel of 58 members of various insurance institutions.

Also, Variable Life Insurance: Current Issues and Developments by Douglas G. Olson discusses insurance benefits based on a cost of living index, commodity market index and stock market index.

Summary

Section I is an introductory chapter which begins with an introduction and the formal statement of the problem under study. Following are discussions of the significance of the study, its scope, and the basic assumptions made. Definitions of terms used are followed by a brief outline or design of the study. The chapter concludes with a review of the literature on the effects of inflation on life insurance.

SECTION II

INFLATION AND THE COMPLEXITY OF THE WHOLE LIFE POLICY

In an attempt to show the complexity of the whole life policy and the effects of inflation, this section offers a brief history and a more detailed explanation of the whole life policy. Also, the advantages of cash values which are unique to the policy are considered as a savings element.

Inflation

In the book, The New Inflation, by Willard Thorp and Richard Quandt, the statement is made, "Moderate inflation is not necessarily all bad because it may encourage full employment and maintain economic growth. Monetary and fiscal policies are probably not adequate for dealing with inflation from other causes because they are likely to arrest inflation at the cost of unemployment."[1] Dr. John T. Fey, vice-chairman of the Equitable Society, attributes this governmental goal of full employment as one of the three major causes of the current problem of inflation in the U.S.[2] On this subject, also, Robert A. Templin,

---

[1] Published by McGraw-Hill, 1959.

[2] The National Underwriter, Life and Health Insurance Edition, September 12, 1974, p. 1.

Senior Vice-President of Northwestern Mutual Life, contends that it is the electorate who is responsible for the inflation and not the federal government or congress.[1] This perspective of citizen-voter responsibility revolves on the premise that people are living in excess of the limits imposed both by the ability of the U.S. economy to produce and by the ability of the government to fund the programs which elected officials have enacted.

Templin continues by asserting that the basic problem is that in the area of government activity, the rationale of the majority of U.S. individuals is, "Everyone else is getting his. I had better get mine."[2] As a consequence, the average citizen first turns to the federal government for anything and everything in the misguided belief that federal funds are free and endless. As a possible solution to the problem of inflation, Templin proposes that every effort be made towards acquiring and operating on a balanced federal budget.[3] In other words, he challenges everyone to assume more of the responsibility of financing one's own livelihood instead of immediately looking for government assistance.

---

[1] Ibid., pp. 14-15.

[2] Ibid.

[3] Ibid.

Both Insurance company executives agree that the solutions to the problem of inflation are difficult to ascertain. Furthermore, it is crucial to look to the long term effects of decisions made now because the simple solutions of arresting inflation in the short term merely compound the difficulties that will be experienced in future years. These two viewpoints involve the long run effects which the whole life policy has as one of its main characteristics. While economic experts and government officials wrestle with proposals which will insure a permanent viable solution to the problem of inflation, the American consumer must continue his struggle with the inflation that has now been appropriately dubbed "Public Enemy #1." He faces the stark reality that if inflation caused another 6.9% average rise in prices in the next five years--as it has in the past 5--21 cents more will be chipped away from the buying power of the 1970 dollar. When this is added to the 28 cents out of every dollar which inflation has already consumed this decade, the future trend reveals that 5 years from now, the dollar will have lost almost half of its value since 1970![1]

The insurance industry by offering for sale the whole life policy exposes itself unquestionably to

---

[1]"Inflation," U.S. News and World Report, Dec. 15, 1975, p. 74.

the adverse effects of inflation and therefore must formulate within its own industry, directives whereby it can continue to function in the economy. Brunell Saum, President of Ohio National Life notes that when times are difficult financially, people have a tendency to save more and buy more life insurance. He continues by saying that their ability to do this results from their cutting back on purchases of such things as automobiles, cosmetics, and vacation trips.[1]

Saum contends that another reason people can continue to buy life insurance is by increasing the amount of borrowing which appears to be employed as an offset to the loss of purchasing power customary with inflation. During the January, 1973 to September, 1974 period, installment credit statistics reveal that consumers are borrowing at 9 times the normal rate of years past.[2] In normal years, consumers had been increasing their installment borrowing by about $2 billion a year. In 1973, however, they increased their borrowing by $18 billion.[3] This tendency of consumer acquisition of credit will be more clearly evident when this report discusses the policy loan opportunities available with the whole life policy.

---

[1] The National Observer, September 14, 1974, p. 3.

[2] The National Underwriter, Life and Health Edition, September 14, 1974., p. 24.

[3] Ibid., p. 25.

At what socio-economic level will the aforementioned increased sales of whole life insurance occur? Benedict A. Presper, Executive Vice-President of Summit National believes that the increased sales are coming only from certain markets--from certain remaining pockets of buying power.[1] The young families constitute a very difficult area to sell the whole life policy because of two factors. One is that many of them are having an especially difficult time making ends meet with their own family budgets. Secondly, and more important, are the increased Social Security benefits and group insurance available at one's place of employment. On the other hand, G. Reese Foote, Jr., Vice-President of Westfield Life, asserts that the increased sales are coming from the high income people who have the ability with the excess amount of income to purchase more whole life insurance.[2] It is apparent, then, from the discussion offered by Presper and Foote, that inflation is creating a situation where some individuals are much more resistant to buying whole life policies than was the case, while others are much more anxious to buy this insurance coverage.

The problem which should contain the main emphasis for marketing the whole life policy is that

---

[1] _Ibid_.

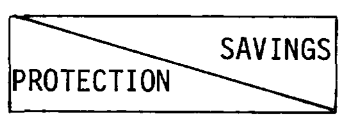
[2] _The National Underwriter_, Life and Health Insurance Edition, Sept. 14, 1974, p. 26.

inflation is undermining the insurance dollar. That is, people are needing and will continue to need more and more coverage--yet it has not been made apparent to them by the insurance industry.

History and Development of the Whole Life Policy

Through a study of the history of the whole life policy and an analysis of its main components and characteristics, it is hoped that the alternatives to formulating the whole life policy which will offer in Section 4 of this report, will provide a permanent and viable solution to inflation which now threatens the existence of the life insurance industry.

The whole life contract was devised about 200 years ago by an English mathematician who was refused life insurance at the age of 46 because he was "too old." He reacted by inventing a policy which would provide insurance at any age for the whole life at a level premium. A later development, non-forfeiture values, led to interpretations that the whole life contract can be split into a combination of declining protection and increasing savings or investment.



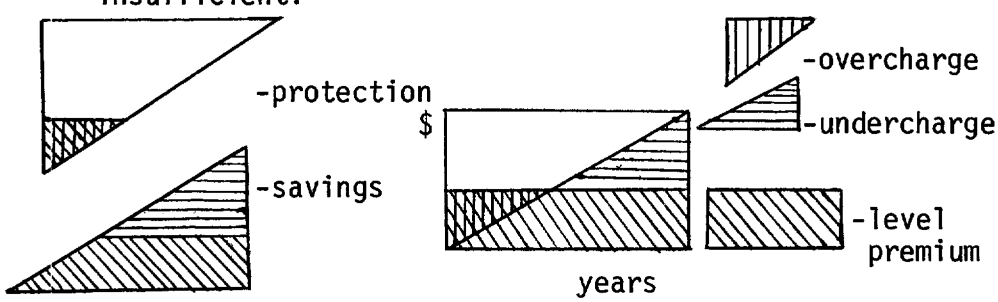
Non-forfeiture values are synonymous with cash values and they tell the policyholder what he can do with these cash values at any time.

For example, an individual may:

1) cash in the policy
2) take out a loan where the interest rate is low because the risk is small
3) purchase paid up insurance or extended term insurance
4) exercise an automatic loan to pay the premium (as long as the cash values last)
5) convert them into an annuity at age 65

A contradiction occurred, however, when the court defined the whole life contract as indivisible. To clear up this discrepancy, the National Association of Insurance Commissioners defined the whole life contract in this manner:

> The whole life insurance contract is a contract of protection--an arrangement by which the insured person, upon regular payment of a level premium, is guaranteed that upon his death his beneficiary will receive a stated amount.
>
> While the central purpose of the contract is insurance protection, the contract also provides auxiliary rights which are available to the policyholder during his lifetime if he does not wish to continue the original arrangement. These stem from the level-premium plan, the effect of which is to collect from the policyholder more than the cost of the pure risk in the early years to permit accumulation of a reserve against the rising risk of the later years, when the level premium alone would be insufficient.[1]



---

[1]The National Underwriter, Life and Health Edition, Sept. 21, 1974, pp. 1 and 6.

The whole life policy, therefore, provides not only a sum of money to enable one to "die even with the world" but also a continuing income to a widow and children, making it possible to keep the home together. In addition, it is purchased to provide a life income to the widow after the children are grown up. It can pay the children's way through college or retire the mortgage on the family's home. Finally, people buy whole life insurance not only for protection purposes but also as a means of accumulating money for their own use in later life. The value may, then, be taken either in one sum or in an income which will continue as long as the insured lives. As a point of information, more life insurance money goes to living policyholders than to the beneficiaries.[1]

These illustrations show that the whole life policy is very flexible, and can meet practically any pure risk situation associated with life--yet it is susceptible to the effects of inflation. The whole life policy, therefore, is both a level premium system of paying for protection over one's lifetime. Also, it is a combination product of decreasing protection and increasing savings where the sum of the two always equals the face amount of the policy.

---

[1]"The Booklet You Have In Your Hand Is Not Designed To Sell You Life Insurance," Institute of Life Insurance 1974, p. 7.

In summary, the whole life policy provides for permanent protection and the idea of a level premium system of paying for protection over one's lifetime.

Cash Values and the Saving Element

The savings aspect of the whole life policy is known as cash value and it is important for this study to consider the advantages which it offers. Otherwise, it would be more beneficial to purchase an insurance policy without an investment consideration and thus reduce the influence which inflation might otherwise have on it.

Cash values of the whole life policy have eight advantages as a savings element:

1) They are a fixed-dollar savings device and are similar, in this respect, to savings accounts, savings and loan accounts, credit union share-accounts and U.S. Savings Bonds.

2) The rate of return on the savings element is not determinable because of the "package" aspect of cash value life insurance. (However it should be viewed as equal to the rate of return on other comparable saving procedures.)

3) They enjoy a substantial income tax advantage over other comparable saving procedures. The income-tax on the so-called "inside interest" is completely deferred, and then it eventually may be completely or almost completely eliminated.

4) They are comparable in liquidity to savings accounts, savings and loan accounts and credit union share-accounts, while being superior to U.S. Savings Bonds.

5) They are reasonably safe. If the policy-holder selects his company carefully from the

standpoint of financial strength, it is unlikely that he will ever be in a situation where the company will not live up to its contractual obligations.

6) They provide an element of compulsion that may be helpful in carrying out a systematic savings program over a long period of time.

7) They may have advantages over money and other types of assets if the policyholder gets into financial difficulties.

8) They provide certain settlement options that may become quite valuable if life annuity premium rates increase substantially in the future (which with inflation, there is every indication that they will).

Summary

Section II has discussed inflation, the complexity of the whole life policy and the cash values characteristic of the whole life policy from the standpoint of a savings element. Section III will begin considering the whole life policy as it is presently written, in terms of it being an effective way of meeting the risk of inflation. Specifically, it will discuss: 1) the advantages and disadvantages of policy loans; 2) the tax advantages of the whole life policy; 3) the merits of the participating mutual versus non-participating stock company; 4) settlements options versus inflation; and finally, 5) variable annuities.

SECTION III

THE PRESENT WHOLE LIFE POLICY VERSUS INFLATION

Section II discussed the complexity of the whole life policy and inflation. Within the whole life policy, the unique characteristic of cash values was viewed from the standpoint of a savings element. Section III combines the whole life policy with inflation in an attempt to determine if the whole life policy, as it is presently written, is an effective means of meeting the risk of inflation. The discussion will include the advantages and disadvantages of policy loans as well as the tax advantages of the whole life policy. In addition, the merits of the participating mutual versus the non-participating stock company will be discussed. Finally, an analysis will be made of both settlement options and variable annuities as a hedge against inflation.

Policy Loans

The adverse effects of inflation create questions in regard to the present formulation of the whole life policy. These questions involve the methods or ways of manipulating the components of the whole life contract to meet the risk of inflation. One method involves what is known as a policy loan where an individual borrows on the accumulated cash value of his policy and then invests this money in areas where he receives a better return. The process of obtaining the loan is an easy process. Unlike other institutions where money is borrowed, the insurance company does not require any explanation as to why the policyholder is in need of the money. Also, the policyholder is not required to produce any collateral for the loan because the policy itself becomes the collateral which will insure repayment of the loan.

Consequently, when the policyholder dies, if any of the cash reserve is left outstanding in the form of a loan, it will be deducted from the face amount of the policy that is to be paid to the beneficiary. Therefore, it is extremely important that an individual policyholder be aware of the impact that a policy loan may have on the goals which he has established concerning his estate upon his death. For example, will the policy still be able to provide a life income to the wife after the children are grown up? Will the death benefit proceeds retire the mortgage on the family's home? The reasons for purchasing an insurance policy should be re-examined by the policyholder to insure that the present advantages which policy cash reserve borrowing affords will not disrupt his future estate plan.

The most important advantage of considering a policy is the low interest rate which is accessed by the insurance company. This low interest rate is especially pertinent to this report's discussion of the effects of inflation because an individual would be able to secure funds at a low interest rate and re-invest them in financial instruments which offer a much higher return. The maximum interest rates on policy loans are usually between 5 and 6 percent.[1] This rate ceiling exists because of state regulation which was initiated to insure that the insurance companies would not capitalize on charging the policyholder equivalent interest rates that are required by other financial institutions in the loaning of money. Without regulation, it is conceivable that insurance companies would require an interest rate that would not be in accord with the minimal amount of risk which it experiences as a result of having the policy serve as collateral.

On the other hand, it is important to realize the situation of the life insurance companies which invest the cash reserves obtained from the whole life policy in long term bonds and mortgages. Although these instruments are safe and secure in terms of an investment, they also have the disadvantage of offering

---

[1] Good Housekeeping, May 1975, p. 184.

a yield of between 2 1/4 and 3 1/2 percent.[1] Therefore, there have been times when the 5 or 6 percent from policy loans is more attractive than the return they receive from the cash reserves being invested at 3 percent. However, when the interest rate in other areas exceeds 6 percent as it has been in recent years with inflation, a policy loan represents an investment loss to the insurance company and an investment gain to the cash-reserve-borrowing policyholder. It is no wonder, then, that presently the policy loans are at a record high since it has been mathematically advisable for policyholders to secure a policy loan at 5 percent and proceed to invest it possibly in a financial instrument bearing a 8 or 9 percent return.[2]

Another advantage which a policy loan offers is that the interest payments do not have to be repaid immediately. By continuing to pay the yearly premium, the interest charges will be covered. Also, a policyholder has the right to borrow against the full amount of the built-up cash reserve. Furthermore, the procedure for borrowing is relatively easy enabling money to be in the hands of the policyholder within two weeks of his application to the company. The

---

[1]Halsey D. Josephson, Life Insurance and the Public Interest, Crown Publishers, Inc., NY, 1971, p. 21.

[2]William H. Rodda, The Question-and-Answer Insurance, Prentice-Hall, Inc., 1975, p. 47.

one disadvantage of processing a policy loan is that a person who borrows is two to three times less likely to maintain the policy or keep it in effect.[1] When one considers the importance of the whole life insurance policy to individuals and society, it is important to consider the implications that may arise from a policy loan.

Finally, the policy loans of the whole life contract developed one of the most controversial subjects in the life insurance industry--financed life insurance. Financed life insurance is a method of buying a whole life policy on borrowed dollars, and deducting the interest on the loan for income tax purposes.[2] It is apparent that the immediate advantages are reserved for those individuals in society who fall within a high-tax bracket. On the other hand, as one can realize from the high incidence of policy lapses, it is a method of purchasing insurance which should not be considered by everyone. When the cash values of the policy are borrowed each year with the balance contributed by the policyholder, the premiums are put on a net payment basis. Normally, there is nothing left if he discontinues payment on the

---

[1] Good Housekeeping, May 1975, p. 186.

[2] William J. Casey, Life Insurance Desk Book, Institute for Business Planning, 1965, p. 182.

policy. In other words, while an individual technically owns a whole-life policy, when he uses borrowed dollars to pay the premiums, in effect he has mortgaged the policy and unless the loan is repaid, the policyholder has forfeited the following:

1) the option of acquiring paid up insurance at a reduced amount;
2) the option to withdraw the cash value in the form of an annuity;
3) the option to buy extended term coverage;
4) the option of an automatic loan to pay a premium.

Tax Advantages of Life Insurance

People are not usually moved to buy a whole life insurance policy because of its tax advantages. From the previous discussion, it is apparent that whole life contracts are made by the policyholder for replacement of his economic value to his family, for peace of mind, for financial independence, for estate conservation, or for sound business purposes. However, when people purchase policies for these purposes, they automatically acquire tax-favored property. One of the more common tax advantages is the free federal income tax status of the death proceeds for a whole life policy. Secondly, neither the cash reserve nor the 2 1/2-3 percent guaranteed interest rate paid by the insurance company on this reserve is taxed. Most policyholders are not aware of these tax advantages. Therefore, a competent insurance agent or a knowledgeable lawyer could manipulate this tax favored property i.e. the whole life insurance policy, to the best advantage of the policyholder. The monetary savings offered by these tax advantages constitute one other way that the whole life policy is an effective way of meeting the risk of inflation.

Participating Mutual Company versus Non-Participating Stock Company

In an attempt to discuss the merits of the participating mutual versus the non-participating stock company, it is important to first define each. A mutual life insurance company is a purely cooperative association in which the members obtain insurance at cost--whatever that may be i.e. it could vary. On the other hand, a stock life insurance company is characterized by the fact that policyholders are customers paying a fixed price for insurance. Such companies are formed or financed by persons not necessarily insured in the company but who wish to make a profit carrying on the business of life insurance. It is interesting to note that most life insurance companies are stock companies but the big successful life insurance companies are mutuals.

As a further classification, a participating policy is one which pays dividends. The dividends paid by a mutual company, then, reflect the actual cost of the life insurance for each year in that it is a return of the "overcharge" paid by the policyholder for the cost of his coverage i.e. a return of the premium. A pegged non-participating rate reflects only the conservatively assumed cost of insurance protection at the time of the issue.[1] Thus, the safety margins go directly to the policyholders in mutual policies while in stock companies, they pass to the stockholders. The impact of dividends on participating policies is dramatically revealed in the 1970 experience of the New York Life Insurance Company. As of June of that year, 170,000 policyholders were receiving annual dividends in excess of their premiums. Consequently, instead of paying on their premium due dates, they were receiving money. A total of 600,000 policyholders were receiving dividends in excess of 75 percent of their premiums and 98.6 percent of all the insured in 1953 or before were receiving 1970 dividends that exceeded 50 percent of their annual premiums.[2]

---

[1]Joe B. MacLean, Life Insurance, Collier Books, 1965, p. 20.

[2]Life Insurance and the Public Interest, Crown Publishers, Inc., NY, 1971, pp. 29-30.

Table I illustrates the savings which are afforded the policyholder when he purchases a whole life policy from a mutual life insurance company instead of a stock non-participating or stock participating policy.

In summary, non-participating policies have been the most costly while participating policies issued by mutual companies have been less costly than participating policies issued by stock companies.[1] These savings can be an effective hedge against inflation by enabling an individual to purchase additional insurance coverage. In doing so, he can acquire the insurance at a wholesale price since there is no commission to be paid to a sales agent. Also, a policyholder may invest this overcharge in financial instruments which will yield a higher return. When all of these factors are combined to combat inflation, the whole life policy reveals that its present formulation offers alternatives to the reality of allowing inflation to affect the policy unchecked.

Settlement Options versus Inflation

Insurance proceeds payable on the death of the insured or the cash reserve when the policy is cashed in can be distributed in five ways. These methods in which whole life policy proceeds can be received

---

[1] Dr. Joseph M. Belth, The Journal of Risk and Insurance, Sept. 1970, p. 42.

TABLE I[1]

$10,000 Whole Life Policies by Men: Age 35, Who Bought Their Policies in 1935, 1945, 1950			
	Average of 3 Non-Participating Policies--Stock Company a) Equitable of Iowa b) Connecticut General c) Aetna	Average of 3 Participating Policies--Stock Company a) Equitable of Iowa b) Connecticut General c) Aetna	Average of 3 Part. Policies--Mutual Company a) Northwestern Mutual b) New York Life c) Connecticut Mutual
Gross Annual Premium	$ 186.33	$ 232.57	$ 229.03
Annual Net Premium over 20 years	186.33	171.97	154.57
Total: 20 Net Premiums	3,727.00	3,474.23	3,090.90
20th Year Cash Value	3,393.33	3,650.07	3,534.00
20th Year Result	333.66 (Cost)	175.84 (Gain)	443.10 (Gain)

[1]Dr. Joseph M. Belth, The Journal of Risk and Insurance, Sept. 1970, p. 42.

are called settlement options. It is important for this discussion on settlement options versus inflation to examine the attributes and characteristics of each option to realize which option will most adequately meet the risk of inflation. All but one of the five options are tremendously affected by inflation. First, there is the interest option where the proceeds remain with the insurance company which then pays the beneficiary a guaranteed rate of interest which usually varies from 2 to 3 1/2 percent.[1] When compared with the other options available to invest one's money, it is immediately apparent that this first option will suffer most from inflation since the beneficiary simply is investing in an insurance company.

The second option which is available with the whole life policy is the fixed period option where the proceeds are held by the insurance company and paid to the beneficiary in equal or nearly equal installments over a specified period of time. These installments will be paid for the definite period of time specified in the option whether or not the primary beneficiary lives for the duration of the periods specified. The amount of these payments will be increased if any additional interest is allowed by the company. However,

---

[1]William J. Casey, Life Insurance Desk Book, Institute of Business Planning, 1965, p. 25.

with the conservative investment procedures of insurance companies, inflation will adversely affect this option, also. Thirdly, a policyholder may stipulate an amount of money to be paid to the beneficiary periodically until the insurance proceeds and the interest accumulated on them are exhausted. This is known as the fixed amount option where excess interest payments by the insurance company would be used to lengthen the period during which payments are made rather than to increase the amount of the periodic payments. Along with the inflation aspect, the fixed amount option does not afford the beneficiaries the flexibility to contend with occassional emergency expenditures.

The fourth settlement option is the life income option where the beneficiary will receive a fixed income for life. The policyholder, in essence, is setting up an annuity for his beneficiary. This life income option can be arranged in a variety of ways depending on the preference, needs, and desire of the policyholder. With inflation, however, the policyholder's preferences as to how the proceeds of his policy are to be distributed should be limited to the fifth settlement option, namely the cash settlement or lump sum option. Strictly speaking, this is not a settlement option because most whole life policies are set up this way, where in the absence of any instructions to the contrary, the insurance company sends along its check for the entire amount due. This option is the best way of handling the proceeds of a whole life policy because the beneficiary is able to invest this income tax-free sum into any of the financial instruments which will offer a higher yield than the insurance company. One objection is inevitably raised to the lump sum option and it relates to the recipient's ability to handle the proceeds of the policy. However, with the trust officer of a bank being willing to competently and effectively handle a lump sum from the insurance policy, the other four methods do not offer reasonable alternatives to meeting the risks of inflation.

Variable Annuities

Annuities meet some of the problems of those who are about to retire. The idea of an annuity is that no one can count on dying at the average age. An annuity, therefore, is a contract under which one receives funds from his retirement until the day he dies. As long as prices stay about where they are when the annuitant enters into the annuity agreement, he will be in good financial condition. However, inflation will bring him to the realization that the income he planned to retire on will be heavily discounted in the future. To protect himself against a rise in the general level of prices, either before or after he retires, he can buy a variable annuity.[1]

The individual agrees to pay, for example, $400 a year to the insurance company for 30 years (assuming he is 35 years old). The company will not put his money in bonds and mortgages as is the usual investment procedure. Instead, it will buy common stocks which are sensitive to fluctuations in the value of the dollar. If prices go up, the value of the common stocks will probably go up, too. The effect of a variable annuity as far as the annuitant is concerned is somewhat the same as if he owned a portfolio of common stocks. For example, the $400 a year payment is converted into units and is a fractional part of the portfolio of common stock. The unit price varies from $ .90 to $1.20 per unit depending on the value of the stock. It is advantageous to have the price of a unit be low when it is bought and high when the annuity goes into effect.

An individual can sell his stock and withdraw from the annuity at any time. The insurance company also receives a small percentage for managing the portfolio. The intent of the variable annuity which makes it so important for this discussion about

---

[1]William A. Hyde, Insurance Simplified, The National Underwriter Company, 1969, p. 165.

inflation is to have an income in future years that will fluctuate with the variations in the purchasing power of the dollar.[1]

Summary

Section III has discussed the whole life policy as it is presently written, in terms of it being an effective way of meeting the risk of inflation. More specifically, the discussion involved the advantages and disadvantages of policy loans as well as the tax advantages of the whole life policy. In addition, the merits of the participating mutual life insurance company were illustrated as opposed to the non-participating stock life insurance company. Finally, settlement options and variable annuities were evaluated in terms of meeting the risk of inflation.

Section IV will present an alternative method of formulating the whole life policy to meet this inflation risk. Included in that discussion will be an explanation of variable life insurance. At the same time, Section IV will examine the advantages and disadvantages of increased government regulation of the insurance industry as well as the possible benefits arising out of social insurance.

---

[1] William H. Rodda, The Question-and-Answer Insurance Deskbook, Prentice-Hall, Inc., 1975, p. 301.

SECTION IV

Section III analyzed the present formulation of the whole life policy and the extent that it is able to effectively meet the risk of inflation. The nature of policy loans and the tax advantage available in a whole life policy were included in the discussion. Along with a study of the participating mutual life insurance company as compared with the non-participating stock life insurance company, an evaluation of settlement options and variable annuities was made in relation to inflation. Section IV presents an alternative method to formulate the whole life policy to meet this inflation risk. This method involves an explanation of variable life insurance. Secondly, Section IV will offer an analysis of the advantages and disadvantages arising out of government regulation of the life insurance industry. Finally, this analysis will lead to discussion of social insurance.

Variable Life Insurance

The adverse effects of inflation in terms of erosion of the value of the dollar are experienced more intensely in the whole life policy because it deals with fixed dollar concepts. With this in mind, the apparent change in demand for life insurance might be interpreted as a signal that, as inflation has become more prominent especially in the last five years, potential policyholders are questioning the value of the security provided by a long term contract with constant dollar benefits. This suggests that life insurance companies might improve the types of policies they sell by offering contracts where the obligation of the company depends on the investment performance of a portfolio of common stock. If the market value of this type of equity tends to keep pace with inflation (at least in the long run), benefit payments to the policyholder will maintain their purchasing power.

Consequently, there has been a critical need for a variation of the whole life policy which would guarantee the purchasing power of the dollar. One way of satisfying this need would involve a variable life insurance plan. What is variable life insurance? Very simply, it is life insurance that varies, in terms of both face amount and cash value--and sometimes premium.[1] This is accomplished by either of two product designs: 1) an index-linked or equity-linked product. The index-linked product is a contract where the face amount of the policy varies with the consumer price index. In equity-linked variable life insurance, the face

---

[1]Robert A. Beck, CLU, Variable Life Insurance: A Perspective on Issues and Current Developments, Insurance Department University of Pennsylvania, 1971, p. 2.

amount varies with the investment performance of common stocks. It has often been suggested that the index and equity concepts be combined so that the death benefits would increase with the cost of living, but cash values would depend on the performance of a separate portfolio of common stock. The theoretical and legal frame-work for such a life insurance policy has not been developed, but it is certainly possible in the near future. This type of policy could be viewed from two different perspectives. Some individuals may feel that it combines the needs of beneficiaries with the appeal that an equity investment offers. Other people, however, may feel that the policyholder deserves guarantees against inflation for all his benefits, including cash values.

There have been numerous proposals for developing a variable life insurance policy using both of these concepts either individually or together. For purposes of this discussion, an equity-based variable life insurance policy will be analyzed based on the theory that common stock offers the most effective method of meeting the risk of inflation. It is interesting to note, however, that the old adage of common stock providing a hedge against inflation has come under fire in recent years--and not without some justification. The Standard and Poor's composite index of common stock prices fell by 40 percent from the first quarter of 1973 to the last quarter of 1974.[1] At the same time, consumer prices were soaring at an annual rate of over 10 percent--the highest rate since 1947.[2] These two forces acting together caused the purchasing power of common-stock holdings to decrease by 50 percent. Thus, the theory that, as the Dow Jones goes--so goes the Consumer Price Index, was substantially disproved.

But a cliché by definition must be true and data gathered by the First National City Bank of New York supports the idea that common stocks do act as a hedge against inflation. The crucial element that the bank officials state in their "Monthly Economic Letter" is time. Life insurance companies, therefore, are headed in the right direction in their attempts to formulate a variable life insurance policy. Since common stocks are based on what an investor expects a company to earn in the future on its plant and equipment, common stocks will offer a better hedge against inflation than money and a more certain hedge than bonds. The reason for this is that in inflation, the costs of a company rise to the same degree as its nominal earnings. Consequently, the price of stock will increase in the same proportion

---

[1]"Monthly Economic Letter: First National City Bank of New York," Sept. 1975, p. 12.

[2]Ibid.

as the rate of inflation. In other words, the real purchasing power of the company's stock would be the same as it was before the inflation rate increased.

There still remains a controversy over the effectiveness of the stock market regarding inflation. One critic of this concept is Burnell Saum who is President of Ohio National Life Insurance Company. He observes that when inflation is running rampant, people are less inclined to assume any speculative ventures such as investing in the stock market. Therefore, he disagrees with the economic expert's theory that in a period of double digit inflation, the stock market would be an effective hedge.[1]

On the other hand, individuals such as Robert A. Beck, Executive Vice-President of Prudential Insurance Company of America believes that common stock has received a great deal of consumer interest. He points to the increased sales of mutual funds and other equity funded arrangements to support his contention that in this period of inflation, inflation-consciousness has become a large part of the U.S. economy and of consumer's thinking. As a result, equities have, in fact, been widely regarded as an inflation hedge.[2]

---

[1]"The National Observer", Sept. 14, 1974, p. 14.

[2]Robert A. Beck, CLU, Variable Life Insurance: A Perspective on Issues and Current Developments, Insurance Department University of Pennsylvania, 1971, p. 3.

While it is important to be conservative with one's financial resources in a period when the inflation rate is high and money is not abundant from the consumer's viewpoint, immediate steps should be taken to meet the future implications of this dollar devaluation. A variable life insurance plan where the death benefit varies with an equity portfolio is a step in that direction.

Before a determination can be made as to the most effective method of formulating the variable life insurance policy, it is important to briefly discuss the nature of a life insurance cash reserve. In computing the premium that an insurance company will charge for a fixed benefit policy, the company will assume that a specific investment return will be earned on the assets where the cash reserves are invested. This is known in the insurance industry as the assumed investment return (AIR). If the company fails to reach its planned AIR, it also will be unable to meet its financial obligations to the policyholders. On the other hand, if the actual investment return is greater than the AIR, these excess earnings will contribute to the dividend. Under the variable life policy, however, the difference between the actual investment return and the AIR is used to bring about changes in the face value of the policy.

The cash reserve under a whole life policy is large enough to be efficiently adapted to the variable life design versus the endowment or term policies which possess a maximum and minimum cash reserve respectively. At the same time, the whole life policy's cash reserve is not of sufficient size to be considered as an investment contract and thereby fall under the jurisdiction of the Securities and Exchange Commission (SEC). If the variable life insurance contract is considered an investment instead of insurance, it would be subject to regulation by the SEC in addition to the state insurance departments.

SEC regulations would include the following: disclosure requirements; a review of sales literature and techniques; and a limitation on the sales commission which would prevent successful marketing of the variable whole life policy alongside the fixed benefit whole life policy.

Within the realm of equity-based variable life insurance, there are several ways that the whole life policy can be formulated to effectively meet the risk of inflation. The method of designing the whole life policy which insures the greatest sensitivity to investment performance of the portfolio is the unit variable method. This method is characterized by variable premiums as well as a variable face value. The name unit variable comes from the fact that premiums and benefits are expressed in terms of units rather than dollars. At the time the policy is sold, each unit has a specified monetary value. As time goes on, this value will either increase or decrease depending on the investment performance of the common stock portfolio. For example, one might pay 50 units a year for a policy with a face value of 1000 units.

If the value of the underlying unit increases 50 percent, then the dollar value and the dollar yearly premium will also increase by 50 percent. Table II[1] helps illustrate the sensitivity of the unit variable method to investment performance. In relation to inflation, there is a ten-fold increase in death benefits when valued at constant dollars. The premiums will also increase in these same proportions.

All the variable policy designs guarantee that the face value will never drop below the original amount and the premium charge for this guarantee is very small. Even though the face value in constant dollars deteriorated in the first ten years in Table II, the policyholder was far better off in 1970 with this type of coverage than with a traditional fixed benefit policy. It should be noted that these results depend

---

[1] Insurance Insights, Mark Green and Paul Swadener, South-Western Publishing Co., 1974, p. 316.

TABLE II

ILLUSTRATIVE. FACE AMOUNT FOR $10,000 VARIABLE WHOLE LIFE POLICY ISSUED TO A MALE AGE 35 WITH ASSETS INVESTED IN STANDARD AND POOR'S COMPOSITE 500 AND AIR EQUAL TO 3 PERCENT.

Unit Variable Method

Year	Age	Actual $ Amount	Constant $ Amount
1940	35	10,000	10,000
		8,807	8,378
		7,697	6,613
		8,662	7,010
		10,555	8,403
1945	40	12,192	9,489
		16,153	11,592
		14,295	8,967
		14,471	8,427
		14,978	8,806
1950	45	16,792	9,779
		20,538	11,075
		24,858	13,114
		28,245	14,789
		27,738	14,462
1955	50	39,261	20,535
		51,009	26,285
		52,717	26,251
		46,674	22,618
		61,900	29,761
1960	55	68,296	32,326
		65,262	30,564
		82,942	38,402
		73,026	33,399
		86,196	38,912
1965	60	97,251	43,183
		105,988	45,732
		94,733	39,751
		110,716	44,579
		123,424	47,166
1970	65	106,395	37,488

on the following facts: 1) the year in which the policy was issued i.e. 1940; 2) the age of the policyholder i.e. 35; and 3) the yield rate of the Standard and Poor's Index. Changes in any of these variables could have a significant effect on the changes involving the death benefit. Nevertheless, the results of simulating a variable life insurance policy over a 30 year period from 1940 to 1970 clearly show that the variable life insurance policy offers a partial solution to the problem of inflation and risk management.

In conclusion, variable life insurance exemplifies a definite change in the basic theoretical concepts of the life insurance industry. Before the variable life policy, insurance companies operated on the principles that they were to provide a policy with guaranteed benefits and also to take over the mortality, expense and investment risks of the policyholder. However, variable life insurance essentially shifts most of the investment risk back to the policyholder, leaving the company with only the risk of unexpected expenses and mortality costs. The investment risk that remains with the insurance company can be minimized by not providing any guarantees with regard to the cash values of the policy. Since the cash reserves in a variable life policy reflect the actual performance of the common stock portfolio, they cannot be determined in advance which explains this refusal of a guarantee by the insurance companies. In this context, the investment element of the variable life insurance contract resembles a share in an investment company. In addition, if the companies were to guarantee the cash reserves, the premium for a variable policy would be similar to that for a fixed-benefit policy. Another way that insurance companies can minimize the investment risk is to utilize an extremely conservative investment return assumption (AIR) in calculating the premium.

The choice between a participating fixed benefit policy and a variable benefit policy with a guaranteed minimum face value benefit and a unit variable method design involves several considerations. The variable life insurance policy must yield greater benefits on its common stock portfolio than the combination of the fixed benefit policy with its dividends.

With the magnitude of inflation both now and in the future, the variable policy will definitely yield these greater benefits because it implements one of the most effective hedges against inflation, namely, common stock. At the same time, a prospective policyowner must realize that the variable policy does not provide the same policy loan privileges of the fixed benefit design. A policy loan privilege would result in speculation by the policyholder. If he believed that the common stock in his portfolio was currently overvalued, and that the value of his account would soon diminish, he could borrow his cash reserve. If his speculation was correct, by repaying the full dollar value of the loan, he would be credited with more insurance than currently held by those who had left their total funds with the company since his new account would be of greater value.

At the present, the variable life insurance policy is an effective alternative method of formulating the whole life policy to meet the risk of inflation--in spite of the apparent disadvantages of such a contract.

Government Regulation of the Insurance Industry

The government in the United States is structured so that it may operate to represent the combined judgment of the people. Although there was not any regulation of insurance in the early years of the industry, it is apparent by the variety of laws enacted in this regard that the United States citizens feel that insurance is now too complicated to permit unrestricted bargaining between individual insurers and prospective policyowners regarding the type of coverage and the price.

Insurance is considered by judicial action to be a part of interstate commerce. Thus, the power to regulate the insurance industry lies in the hands of the federal government as well as with the states. When one considers the whole life contract in particular, he comes to realizations which may be good reasons to substantiate this government intervention. The whole life policy is a promise by the insurance company to pay an amount of money or to perform a function for the insured (example: settlement options, annuities, etc.) if certain specified events should occur in the future. It is difficult for the ordinary policyholder to determine whether the insurance company is financially stable. It is also difficult for an insured individual to check all of the policy conditions to see that the coverage is what he desires and needs.

Government regulation of the insurance industry has several objectives which include the following:[1]

1) The primary purpose of regulation is to make certain that the insurance companies are solvent and are in a financial position to pay their claims.

2) Supervision over policies and forms helps to assure proper language and that there are no hidden clauses that would prevent an insured from collecting a proper claim.

3) The price of insurance is regulated to make certain that the rates are fair and in relation to the risk.

4) There is both state and federal legislation aimed at preventing the use of unfair trade practices such as deceptive advertising.

---

[1]William H. Rodda, The Question-and-Answer Insurance Deskbook, Prentice-Hall, Inc., 1975, pp. 64-65.

5) Insurance agents are subject to supervision and licensing. This is to assure that the agent has a reasonable knowledge of the insurance that he is selling.

6) Regulation is also intended to raise revenue for government. Premium taxes, income taxes, and other business taxes to which insurers are subject, provide large amounts of revenue for the states, municipalities, and for the federal government. The tax revenue of the states from insurers exceeds by many times the cost of protecting policyholders.

While the objectives of government regulation appear to offer a permanent, viable solution to problems which arise from the tremendous growth and influence of the insurance industry in the economy, several individuals believe that the idea of government regulation has gone too far. One such person is James S. Bingay who is President of the Mutual of New York. He has stated, "We must vigorously resist the trend toward regulatory overkill in the name of consumerism."[1] Government regulation, he contends, should be the major concern of the life insurance industry for it will stifle initiative, inhibit growth and progress, and sacrifice long-term achievement for short term benefits.[2]

An area of insurance in which government might wish to intervene is the use of agencies to distribute or market the whole life policies. By discontinuing

---

[1]"The National Underwriter"(Life and Health Edition), Sept. 12, 1974, p. 1.

[2]<u>Ibid</u>.

or modifying the agency system, it is felt that the price of insurance will be subsequently lowered. However, this savings must be considered in light of the professional service which a good agent affords his clients. From a more realistic viewpoint, chaos would invariably result if the government opted to impose such legislation.[1]

At the same time, a greater discussion has involved the setting of insurance rate levels by government legislation. While there would be a noticeable benefit to the policyholder in the short run, the long range problems of inadequate rates will serve to decrease the marketing capacity of the whole-life policy by the insurance company to the consumer. Also, it will foster undesirable claim adjustment practices as well as limit any initiative asserted in the direction of innovating the whole life policy. Finally, the old economic adage of, "There's no free lunch" would serve to explain the fact that the long range creation of financial instability within the insurance industry will automatically necessitate the higher rates which the government regulation sought to reduce in the first place.

Along these lines, the objective of standardizing whole life policies and coverages has its advantages

---

[1] Ibid., pp. 24-25

and disadvantages. Standardization allows a prospective policyholder the opportunity to shop around for price without having to worry about policy variances. On the other hand, it will severely limit the flexibility that the whole life policy is known for as well as preventing any experimentation with the policy which is a prerequisite for its continued improvement.

Finally, the state's regulatory power to set the interest rate on cash reserve policy loans would serve as a definite advantage to the policyholder. However, after viewing the implications of such action in the over-all economy, one realizes that this procedure dislocates the supply of capital and mortgage money which life insurance companies make available to the community. In addition, state regulation of the policy loan interest rates could adversely affect the smaller and less financially sophisticated policyholder who is like the consumer who must assume the cost of shoplifting in the retail area of the economy. In other words, this type of policyholder must assume the burden for the inconsistencies in the operation of the insurance industry.

In defense of government regulation, Senator Philip Hart proposed The Consumer Insurance Information and Fairness Act on July 7, 1975.[1] He felt that the

---

[1]The National Underwriter, (Life and Health Edition), August 2, 1975, p. 2.

findings of the Institute of Life Insurance made government regulation necessary when one considers that only three out of every ten people that were polled, who would buy any form of life insurance, think that they know what they are doing. Secondly, the Institute's study reveals that 6 out of 10 people consider life insurance a basic necessity along with food, clothing, and shelter. Finally, only three out of every 10 people sincerely believe that the insurance company gives one his full money's worth when he purchases a policy.[1]

Senator Hart believes that every agent should be independent so that he would not be forced to sell an inferior or high cost policy as a captive agent in a company. As he stated in his remarks to the Senate on July 7, 1975 when he introduced the Act, "How objective can an insurance agent be if he only works for one company?"[2]

In essence, the legislation would empower the Federal Trade Commission (FTC) to establish a national standard as to the basic cost and benefits of a life insurance policy which in turn will be made available to the consumer. When one considers a final statistic

---

[1] Ibid.

[2] Ibid.

from a 1974 Institute of Life Insurance survey which is that 80 percent of the life insurance policies sold are handled by 98 percent of the high cost companies (based on computing that 2 percent or 40 of the companies with the lowest priced policies are dealing in only 20 percent of the life insurance market.)[1]

The goals of this legislation are to provide accurate, reliable, and clear information to consumers about the costs and benefits of the life insurance that they are buying. In conclusion, government regulation is an important force in shaping the future of insurance operations. As with inflation, though, the long term effects of government intervention should be weighed against the short term benefits to the consumer.[2] Nevertheless, the two opposing sides on the topic of government regulation of the life insurance business would agree that extensive regulation is a fact of life in the insurance business.

Social Insurance

Insurance companies are in business to make a profit or in the case of mutual companies, to provide insurance to their members at a low cost. In order to function properly, insurance must reject those

---

[1] Ibid.

[2] Herbert S. Denenberg, Insurance, Government, and Social Policy, Richard D. Irwin, Inc., 1969, p. 365.

individuals who have high risk characteristics. The insurance industry finds itself faced with the dilemma of assuming a social obligation of providing insurance for everyone who faces a risk versus establishing underwriting methods which will enable their continued existence.

While assigned risk plans have worked in regards to workmen's compensation and automobile insurance, the area of life insurance has maintained its rigid guidelines of--high risk, no insurance coverage. At the same time, however, the life insurance industry fears any government plan of insurance for it poses a threat to its continued existence.

Richard M. Hoe observes another aspect of social insurance which the life insurance industry is helping to create. In his article, "Federal Life Insurance Plan," Hoe fears that if insurance companies continue their trend toward pricing and underwriting policies, a federal life insurance plan will be necessary.[1] This plan could be funded by a 20 percent increase in Social Security taxes and would offer life insurance to the poor and middle class individuals who need this coverage the most but only in amounts of $5 or $10 thousand. He observed another trend that the competent agents are in search of large estate tax

---

[1]The National Underwriter (Life and Health Edition), Sept. 14, 1974, p. 4.

sales or pension trust business. As stated early in this report, young families are unable to acquire the life insurance protection they need. The insurance industry will have to take steps to assume its social obligation to insure those individuals who qualify for insurance but do not constitute large premiums or large commission sales. Furthermore, it must strive to formulate a procedure for providing life insurance coverage to those individuals who might not qualify for a low risk classification. The life insurance industry has nothing to lose and everything to gain for if action is not taken soon, the will of the people through a federal life insurance plan will inevitably bring the elimination of the industry from the market place.

Summary

Section IV employed a discussion of variable life insurance to present an alternative method to formulating the whole life policy in order to meet the risk of inflation. Secondly, it analyzed the advantages and disadvantages arising out of government regulation of the life insurance industry. This analysis led to the final topic of discussion for Section IV, namely social insurance.

SECTION V

SUMMARY AND CONCLUSIONS

This section provides a summary of the study and the conclusions drawn from it. The summary portion of the section is divided into parts which correspond to the previous sections. Following each part, then, are the specific conclusions drawn from the summarized section.

The Problem

Russell Baker in his essay, "The Aged, Shopping" expressed an opinion which, in turn, initiated the question of how inflation affects the whole life insurance policy. In Baker's words:

> Perhaps old people would turn off and tune out the news if it switched from entertainment to reality and dealt with the pain of not being able to afford an orange or the embarrassment of delaying the checkout line to take back the crackers 1965 dollars can no longer buy.

It was this observation which prompted a discussion on inflation and the whole life policy.

Statement of the Problem

The formal statement of the problem presented in Section I was the following:

> The purpose of this study is to analyze and define the role of life insurance, present and future, in meeting the risk of inflation. A specific type of life insurance policy, namely the whole life policy, will be considered to determine 1) whether

> the whole life policy is affected by inflation, 2) whether the whole life policy as it is now written is an effective way of meeting the risk of inflation, and 3) what alternative methods of formulating the whole life policy might be considered to successfully hedge against this risk.[1]

Section I continued with brief discussions of the significance of the study, its limitations and scope, and the basic assumptions under which the study was to be conducted. Section I also had definitions of terms that were used while ending with a review of limited literature about the effects of inflation on life insurance.

Conclusions Regarding the Problem

Inflation certainly can be compared to a disease which has taken over the body of the host to the extent that it can only be treated and not cured. The startling fact that a 10% inflation rate compounded annually over 40 years can reduce the purchasing power of $10,000 to a mere $200, raises some very interesting questions. The questions center on the premise that the whole life policy is an entity which should preserve the purchasing power of the dollars that make up its face value. With inflation, however, one realizes that future dollar values in a whole life policy may not be preserved unless a comprehensive analysis is made as to if the policy is affected by inflation.

---

[1]This problem statement appears in Section I, supra, p. 4.

Inflation and the Complexity of the Whole Life Policy

Section II showed the complexity of the whole life policy and the effects of inflation. This was accomplished by offering an explanation of inflation, and a brief history and more detailed discussion of the whole life policy. This was followed by a study of cash values.

Inflation

Inflation has grown to an alarming rate because of a consumer misconception that his tax payments should provide him with a multitude of benefits from the government. This reliance on the government for one's basic needs has created a condition which has chipped away 28 cents out of every dollar in the period 1970-1975. The insurance industry by offering the whole life policy for sale, exposes itself unquestionably to this condition. As a result, inflation is creating a situation where some individuals are much more resistant to buying whole life policies while others are much more anxious to buy this insurance coverage.

History and Development of the Whole Life Policy

From its creation about 200 years ago by a 44 year old man who was refused life insurance, the whole life policy has developed the flexibility to cover practically every life insurance need. With non-forfeiture values, it is evident that the policy combines decreasing protection with increasing savings. Also, the fact that more life insurance money goes to living policyholders than to the beneficiaries illustrates that whole life insurance provides more than a sum of money to enable one to "die even with the world." Thus, while the protection idea is important, the savings element constitutes a major selling point from the standpoint of the consumer.

Cash Values and the Savings Element

The aforementioned savings element is encompassed in the cash value part of the whole life policy. Cash values go beyond the usual liquidity and safety factors that other financial institutions offer to the idea of developing a compulsory savings program which enjoys a substantial tax advantage.

Conclusions Regarding Inflation and the Complexity of the Whole Life Policy

Following are the conclusions drawn specifically from Section II:

1) Moderate inflation encourages full employment and economic growth. However, a policy of full employment nurtures high inflation rates which can only be controlled by the individual assuming more of the responsibility of financing his own livelihood instead of immediately looking for government assistance.

The insurance industry, by offering the whole life contract, exposes itself to the greatest impact of inflation, namely long-term undermining of the purchasing power of the dollar. Consequently, it must formulate a new whole life policy or modify the present one to maintain its existence in the market place. Inflation is creating a situation where people who are in need of, and qualify for insurance coverage are unable to acquire it for financial reasons.

2) The whole life policy is very flexible and can meet practically any pure risk situation associated with life. At the same time, it provides for permanent protection and the idea of a level system of paying for protection over one's lifetime.

3) The cash values which the whole life policy offers represent the reason why people, even with inflation, purchase this type of policy over a pure protection contract.

The Present Whole Life Policy Versus Inflation

Section III analyzes the combination of the whole life policy, as it is presently written, with inflation. The whole life policy, by its flexible nature, possesses different components which can be used effectively against inflation. The aspects of policy loans, tax advantages of policy ownership, and purchasing a policy from a mutual insurance company were analyzed to see if an effective method of meeting the risk of inflation existed as well as settlement options and variable annuities.

Policy Loans

Obtaining a policy loan is a very easy process. It constitutes a safe extension of credit by the insurance company while it affords an individual a low interest rate which is state regulated. A major concern with policy loans is the high incidence of policy lapses which occur when individuals over-extended themselves in credit acquisition. Also, the goals of purchasing a whole life policy in terms of providing money to the beneficiary is undermined by policy loans which are taken out without careful consideration.

Tax Advantages of Life Insurance

Most prospective policyowners do not realize that when they purchase a whole life policy, they make a contract which has federal income tax freedom regarding death proceeds as well as the interest paid by the insurance company for the use of the cash reserve.

Participating Mutual Company Versus Non-Participating Stock Company

Mutual life insurance companies are organized for the benefit of its policyholders while stock companies are organized to make a profit for the stockholders by providing insurance coverage to the public. While most life insurance companies are stock companies, the large successful life insurance companies are mutuals.

Settlement Options Versus Inflation

Settlement options are the methods by which the proceeds of a whole life policy can be distributed to the beneficiary. Of the five options, the first is the interest option where the proceeds are kept by the insurance company who in turn pays the beneficiary interest at regular intervals. Second is the fixed period option where the proceeds are held by the company and then paid out in equal installments over a fixed period of time. Next is the fixed amount option where the proceeds are paid out in fixed amounts at regular intervals until the funds are exhausted. Then there is the life income option where the beneficiary will receive a fixed income for life. The final option is the lump sum option where the entire amount is immediately paid to the beneficiary upon the policy-owner's death.

Variable Annuities

Annuities meet some of the problems of people who are about to retire. It is a contract where one receives funds from the time of his retirement until the day he dies. With a variable annuity, the insurance company will buy common stock with the individual's money. He can sell his stock and withdraw from the program at any time. Common stock is purchased by the insurance company instead of the usual bonds or mortgages because it is more sensitive to fluctuations in the value of the dollar.

Conclusions Regarding the Present Whole Life Policy Versus Inflation

Following are the conclusions reached in Section III.

1) Policy loans are an effective hedge against inflation because they enable an individual to borrow his cash reserve at a statutory, set interest rate and then invest it in financial institutions which offer a higher return.

2) The tax advantages that a whole life policy possesses can be successfully manipulated by a competent insurance agent or a knowledgeable lawyer to constitute still another way that the whole life policy as it is now written provides an effective part to meet the risk of inflation.

3) A participating mutual life insurance company, by passing on the profits to the policyholders instead of the stockholders, represents a monetary savings to the policyowner. These savings can be an effective hedge against inflation by enabling an individual to purchase additional insurance coverage at a wholesale price.

4) Of the five settlement options, the lump sum option is the best way of handling the proceeds of a whole life policy because the beneficiary is able to invest this income tax-free sum into any of the financial instruments which will offer a higher yield than the insurance company.

An Alternative to Formulating the Whole Life Policy

Section IV discusses the variable life insurance policy as constituting an alternative method of formulating the whole life policy to meet the risk of inflation. In addition, the consequences of increased government regulation of the whole life insurance industry were offered in order to determine the direction that the insurance industry will take in the future. Along these lines, a report on social insurance was offered in the light of a possible outgrowth of government regulation.

Variable Life Insurance

In order to preserve the purchasing power of the dollar which is continuously being undermined by inflation, variable life insurance is characterized by a face amount, cash value, and sometimes premium that varies. The design of this policy that the report analyzed was one that was linked to an equity based concept where the face amount varies with the investment performance of common stocks. As a further delimitation of the analysis, only the unit variable method of initiating an equity-linked variable life policy was discussed because it was the most sensitive to the investment performance of common stock which in turn, is considered the most effective hedge against inflation. The unit variable method is characterized by variable premiums as well as a variable face value. The name "unit variable" comes from the fact that the premiums and the benefits are expressed in terms of units rather than dollars. It guarantees that the face amount of the policy will never drop below the original amount but it is unable to guarantee the cash values in advance because they are determined by the actual performance of the common stock portfolio. While it does not offer the policy loan privilege because of the chance of speculative motives on the part of the policyholder, it would have provided a four-fold increase in death benefits when valued at constant dollars over a 30 year period from 1940 to 1970.

Government Regulation of Insurance Industry

The Institute of Life Insurance revealed in a 1973 study that only 30 percent of the people polled thought they knew what they were doing when they bought a whole life insurance policy. This fact was reason enough for Senator Hart to propose The Consumer Insurance Information and Fairness Act to provide accurate, reliable, and clear information about the costs and benefits of life insurance to the prospective consumer-policyowner. An individual who is opposed to government interference in the insurance industry contends that it will stifle initiative, inhibit growth and progress, and sacrifice long-term achievement for short-term consumer benefits.

Social Insurance

The insurance industry has two objectives which are the following: 1) assume the social obligation to provide insurance coverage to everyone, and 2) make a profit to continue its existence. The trade off between these objectives occassionally gives a secondary priority to the social obligation concept. Experts in the insurance industry are concerned that this obligation will be assumed by the government through a federal life insurance plan funded by a 20 percent increase in Social Security taxes. This coverage would be offered to the growing numbers of individuals who do not constitute the "big money" insurance sales. The government as a competitor in the life insurance market would signal the end of the life insurance industry because of the economic consequences.

Conclusions Regarding an Alternative to Formulating The Whole Life Policy

Following are the conclusions reached in Section IV.

1) The variable life insurance policy is the most effective method of formulating the whole life policy to meet the risk of inflation. This results from the fact that the face value is linked to the investment performance of a portfolio of common stock. Consequently, this policy has one of the most effective entities to hedge against inflation as a main component. By shifting the guarantee of benefits as well as the mortality, expense, and investment risks to the policyholder, the insurance company can provide more life insurance coverage at a lower price.

2) Government should approach the idea of regulating the insurance industry in a very cautious manner realizing the following: 1) it operates to make a profit, 2) it must contend with an inflation which government has created through previous intervention in a variety of sectors within the market place, and 3) it should consider the long-range implications of decisions made to benefit the consumer in the short run. Government intervention should act only to correct the abuses that have been created by the insurance industry when the balance between its social obligation and profit motives is favoring the profit concept heavily. At the same time, the complexity and flexibility of the whole life policy dictates that the consumer have access to an unbiased explanation (i.e. government versus insurance industry) of what is involved with purchasing a whole life policy.

3) The actual government intervention into marketing life insurance coverage as a competing entity will expose the life insurance industry to insolvency by economic forces. Government should assume a laissez-faire approach to selling life insurance and serve

only in a correctional capacity. More importantly, it should provide information to the consumer concerning the different life insurance coverages. With perfect information, the consumer, through his decisions, will foster perfect competition in the economy.

SELECTED BIBLIOGRAPHY

Casey, William J. Life Insurance Desk Book. New York: Institute for Business Planning, 1965.

Hyde, William A. Insurance Simplified. Cincinnati, Ohio: The National Underwriting Company, 1969.

Kalowla, John J. Life Insurance and the Public Interest. New York: Crown Publishers, Inc., 1971.

Kimball, Spencer L. and Denenberg, Herbert S. Insurance, Government, and Social Policy. Richard D. Irwin, Inc., 1969.

Life Insurance Fact Book 1974. New York: Institute of Life Insurance, 1974.

Olson, Douglas G. Variable Life Insurance: Current Issues and Developments. Insurance Department: University of Pennsylvania, 1971.

Rodda, William H. The Question-and-Answer Insurance Deskbook. New York: Prentice-Hall, Inc., 1975.

Thorp, Willard M., and Quandt, Richard W. The New Inflation. Philadelphia: McGraw-Hill, 1959

MAGAZINES AND PERIODICALS

Best's Review

Good Housekeeping

Monthly Economic Letter: First National City Bank of New York

National Observer

National Underwriter, (Life and Health Edition)

Retirement Living

U.S. News & World Report

APPENDIX A

Following is an example of a
whole life insurance policy: